IN THE
Supreme Court of the United States
OCTOBER TERM, 1975

No. 75-1556

PUBLIC SERVICE COMMISSION OF THE
STATE OF NEW YORK,
Petitioner,
v.
FEDERAL POWER COMMISSION,
Respondent.

REPLY TO COMMISSION'S MEMORANDUM IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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The Commission's Memorandum in Opposition to the Petitions for Certiorari in these proceedings, defends the Commission's action solely on the basis that it could "properly" interpret its area rate orders, in a manner directly contrary to their admitted intent,[1] in order to effectuate a gradual abolition of the two-vintage rate system established therein by making the new gas rates available to renewal contracts (FPC Memorandum, p. 4). The Public Service Commission of the State of New York (New York) has already pointed out in its petition (pp.

[1] See, *e.g.*, *Permian Basin Area Rate Cases*, 390 U.S. 747, 795-799 (1968).

6-7, 13-14), that the records in both the Commission rate proceedings from which review was sought and in Docket No. R-371, *Area Rates for the Appalachian and Illinois Basin Areas,* leading to Opinion 639, 48 FPC 1299 (1972), upon which the Commission relied for its actions, are totally barren of any valid factual predicate for the elimination of the dual price system established in the area rate cases. Specifically, we pointed out that the Commission's only suggestion as to why the existing two-price system was counterproductive—that a distinction between old and new gas *based on contract date* might result in inhibiting new drilling on acreage already committed to the interstate market in the initial sales contract—not only *could* be cured by making the new gas rate applicable to all new drilling operations, but *had* been so cured, independent of Opinion 639, first in the Optional Procedure for Certificating New Gas Sales, 18 C.F.R. § 2.75, affirmed *Moss* v. *FPC,* 502 F.2d 461 (D.C.Cir., 1974),[2] and then in the Commission's nationwide new gas rates adopted in Opinion 699-H, *Just and Reasonable National Rates for Sales of Natural Gas from Wells Commenced On or After January 1, 1973, and New Dedications of Natural Gas On or After January 1, 1973,* —— F.P.C. —— (unreported) December 4, 1974, affirmed *Shell Oil Company* v. *FPC,* 491 F.2d 82 (5th Cir., 1974), certiorari denied, *sub nom., The California Company, et al.* v. *FPC,* No. 75-1289, *et el.,* 47 L.Ed.2d 394 (June 14, 1976).[3]

[2] The one facet of the Commission's rule set aside by the Court of Appeals was subsequently approved by this Court in *FPC* v. *Moss,* 47 L.Ed.2d 186 (1976).

[3] See also, *Policy with Respect to Sales Where Reduced Pressure, Need for Reconditioning, Deeper Drilling or Other Factors Make Further Production Uneconomical at Existing Prices,* 49 F.P.C. 992 (1973). It should be noted that on June 29, 1976 the Commission adopted an order to implement this policy which, *inter alia,* requires producers seeking higher rates for flowing gas on grounds they can thereby enhance production for the interstate market to detail the cost of their proposed additional operations and the estimated result thereof. 41 F.R. 27828 (July 7, 1976). No such showing was required or forthcoming to secure the higher rates for replacement contracts involved in the present case.

The Court need not consider, however, whether the failure of the Commission's Memorandum or the Court below[4] to direct themselves to the record support for any elimination of rate vintaging would in the context of the millions of dollars involved itself warrant plenary review by this Court. For the Commission on July 7, 1976, less than two weeks after it filed its Memorandum in Opposition to Certiorari here, issued its Opinion No. 770 in Docket No. RM75-14, *National Rates for Jurisdictional Sales of Natural Gas Dedicated to Interstate Commerce On or After January 1, 1973, For the Period January 1, 1975, to December 1, 1976.* In this opinion the Commission, reversing its position adopted on December 4, 1974 in Opinion No. 699-H, *supra,* expressly concluded that it would not move towards the gradual abolition of rate vintaging. On the contrary, it established a four vintage price system.

Under this system (1) gas initially sold in interstate commerce on or after January 1, 1975 or from wells "commenced" on or after that date, would be eligible for a base price of $1.42 per Mcf, with automatic quarterly escalations commencing October 1, 1976 of an additional cent; (2) gas in interstate commerce initially sold, or from wells initiated between January 1, 1973 and December 31, 1974 would have a just and reasonable base price of $1.01 per Mcf, with no further automatic escalations; (3) flowing gas sold under renewal contracts at the ex-

[4] The Court of Appeals majority, in the portions of the opinion cited in the Commission's Memorandum, merely repeated the Commission's language about the alleged failure of a system distinguishing between new and old gas on the basis of contract date to consider the problems of expensive new drilling on dedicated acreage. The Court apparently failed to recognize that this problem had otherwise been cured by the Commission.

piration of initial sales contracts entered into prior to January 1, 1973 will be entitled to a 52 cent base price, with annual escalations of one cent per Mcf; and (4) all other flowing gas will, pursuant to the Commission's Opinion 749 issued on December 31, 1975,[5] receive a base price of 29.5 cents as of July 1, 1976. Pages 11-16 of Opinion No. 770 discussing the establishment of this four vintage policy are set out as an Appendix to this reply since the Opinion has not yet been reported.[6]

Under this latest Commission pronouncement, sales of flowing gas under renewal contracts will still be entitled to the various area new gas rates for the period commencing on the date when rate increases filed pursuant to the policy statement of Opinion 639 were permitted to become effective until June 21, 1974, the effective date of Opinion 699-H, and 52 cents per Mcf plus one cent annual escalations thereafter. But, there no longer can be any attempt to justify either action on grounds that the Commisson is properly moving to eliminate vintaging.

The Commission's right to eliminate rate vintaging is, however, the sole basis upon which the Commission now seeks to justify an action costing gas consumers millions of dollars without any demonstrable results in securing additional gas for the interstate market.[7] It is true that

[5] *Just and Reasonable National Rates for Sales of Natural Gas From Wells Commenced Prior to January 1, 1973*, Opinion No. 749, Docket No. R-478, issued December 31, 1975, (unreported).

[6] While Opinion No. 770 is subject to petition for rehearing and court review, it represents the present thinking of the Commission.

[7] In opposing the extension of the renewal contract concept in Opinion 699, New York expressly stated its belief that examination of the Commission's files would demonstrate little, if any, producer agreement to make additional expenditures in return for the pipeline agreeing to a replacement contract, but that pipelines would nonetheless be compelled to agree to new contracts at higher rates if they wished to purchase any additional gas from such producers. The Commission's decision in Opinion 699-H *supra* did not bother to respond, but the Commission's brief on review of that

the Court below speculated that the additional revenues flowing to the producers as a result of the Commission's largesse might result in a greater expenditure of funds in a gas search effort on behalf of the interstate market—despite the Commission's refusal to tie the increased rates to any additional expenditure or effort on the producer's part. The reason why the Commission properly does not attempt to rely upon such an argument in its Memorandum in Opposition here is clear. There is no record as to the need for additional revenues from flowing gas in the rulemaking proceeding leading to Opinion 639 which was concerned with a proposal to establish a higher rate for *new* gas from the discrete production areas. Moreover, the brief discussion of the matter in Commission Opinion 639 *supra*, 48 F.P.C. 1309-1310, is devoted solely to the alleged disincentives of the existing system of vintaging gas on a contract date basis and does not suggest that increased rates for flowing gas is justified as a revenue producing device.

In short, the only conceivable justification for the Commission's action here has now been effectively eliminated by the Commission's own action. Under these circumstances it would appear appropriate for the Court to grant certiorari, and to remand the case to the Court of Appeals with instructions to set aside the Commission's orders in question with directions for the producers to make appropriate refunds unless they are able to demonstrate that the pipeline and its customers have received, or will receive, discrete benefits commensurate with the increased revenues paid to the producers. At the very

opinion argued (erroneously in our view) that inadequate time had transpired to permit any evaluation of the effects of supplying the Opinion 639 policy. A year and a half later, in Opinion 770, the Commission still refrains from any evaluation of the effect of its replacement contract policy which had then been in effect for over three and one half years.

least, the Court should grant the petitions for consideration on their merits.

Respectfully submitted,

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APPENDIX

APPENDIX A

OPINION NO. 770

Docket No. RM75-14

NATIONAL RATES FOR JURISDICTIONAL SALES OF NATURAL GAS DEDICATED TO INTERSTATE COMMERCE ON OR AFTER JANUARY 1, 1973, FOR THE PERIOD JANUARY 1, 1975, TO DECEMBER 31, 1976

OPINION AND ORDER PRESCRIBING UNIFORM NATIONAL RATE FOR SALES OF NATURAL GAS DEDICATED TO INTERSTATE COMMERCE ON OR AFTER JANUARY 1, 1973, FOR THE PERIOD JANUARY 1, 1975 TO DECEMBER 31, 1976

(Issued: July 27, 1976)

Pages 11-16 read as follows:

C. *Policy Determinations*

After careful review and consideration of all the evidence submitted in this proceeding, we conclude that the new base national rate herein established for 1975-1976 biennium gas should be made applicable where:

(i) The sale is made from a well or wells commenced on or after January 1, 1975;

(ii) The sale is made pursuant to a contract for the sale of natural gas in interstate commerce for gas not previously sold in interstate commerce prior to January 1, 1975, except pursuant to the provisions of 18 C.F.R. §§ 2.68, 2.70, 157.22, or 157.29 (including sales made pursuant to those sections as modified by Federal Power Commission Order No. 491, *et al.*), or 18 C.F.R.

§ 2.75(n), where such a sale is initiated on or after January 1, 1975, provided that no certificate for the subject sale has been issued under the optional procedure (18 C.F.R. § 2.75).[23]

Rather than increasing the rate for new gas qualifying under Opinion No. 699-H to the rate level for post-January 1, 1975 gas, we believe that a separate rate determination is necessary to reflect the additional cost and productivity data gathered for the period from January 1, 1973 to December 31, 1974, and to reflect increased income taxes resulting from repeal of percentage depletion allowances.

Our decision to modify the policy set forth in Opinion No. 699-H,[24] with respect to the effective date on which gas initially qualifies for a new rate, is based on a determination that the increased costs of exploration and production and the decreased productivity of wells should only be reflected in the rates for the corresponding period, and not for a prior period. Since the attendant cost and productivity data for the 1973-1974 biennium can be considered separately, we have determined that the more recent 1975 data should only be considered prospectively and should not affect a 1973-1974 cost-based national rate. The $1.42 per Mcf rate prescribed herein reflects the current costs of finding and producing new gas and exceeds the rate necessary for the lower costs previously incurred in finding and producing gas qualifying under Opinion No. 699-H.

We are aware of the problems occasioned by the continuance of the vintaging concept. The Commission, however, has a responsibility to minimize severe and harmful

[23] 18 C.F.R. § 2.56a(a)(1)(i) and (ii).

[24] See Opinion No. 699-H, —— F.P.C. —— slip opinion at 50.

economic dislocation due to increased rates.[25] In light of the magnitude of the increase of the rate prescribed herein for post-January 1, 1975 gas over the revised rate for 1973-1974 biennium gas, the Commission must abandon its intended policy to establish a single uniform national rate for gas dedicated or wells drilled after January 1, 1973, and must vintage by a 1973-1974 cost grouping to preclude the exaction of excessive and unjustifiable economic rent from flowing gas.[26]

Although the Commission expressed concern in Opinion No. 699-H that such vintaging could discourage the dedication of new gas supplies to the interstate market,[27] we did not anticipate at that time such a dramatic increase in costs and decrease in productivity, necessitating the rate of $1.42 per Mcf.

The Commission also has considered factors other than the traditional cost-based formulary in establishing this rate. We have elicited comments as to the bearing intrastate prices should have on interstate rates and have considered these prices in establishing the rate. In addition, we have considered the Btu equivalency values of residual oil, distillate oil, crude oil, synthetic natural gas and liquefied natural gas. Accordingly, we believe that the price established herein for post-January 1, 1975 gas is sufficiently high to encourage dedication of additional supplies of natural gas to the interstate market and increased exploratory and production activity.

We are aware that the rate prescribed herein for post-January 1, 1975 results in a 173% increase over the base

[25] *Area Rates For The Appalachian And Illinois Basin Areas*, 48 F.P.C. 1299 at 1309-1310 (1972), *affirmed sub nom. Shell Oil Co., et al.* v. *F.P.C.*, 491 F.2d 82 (5th Cir. 1974).

[26] See Opinion No. 699-H, Concurring Opinion of Commissioner Smith —— F.P.C. ——, slip opinion at 4.

[27] See Opinion No. 699-H, —— F.P.C. ——, slip opinion at 50.

rate established in Opinion No. 699-H. However, this disparity is substantially lessened when actual costs for the 1973-1974 biennium are considered in lieu of the projected costs utilized in that proceeding.[28] While actual drilling costs for 1973 approximated those projections made in Docket No. R-389-B, the actual dry hole costs and successful well costs for 1974 were, respectively, 57% and 14% greater than those projected. The average 1973-1974 actual dry hole cost was 35% greater and the average actual successful well cost was 3% greater than the trended values used in Opinion No. 699-H. Similarly, exploration and lease acquisition expenditures were substantially greater than those projected while average productivity fell substantially below that used in Opinion No. 699-H. Moreover, it is necessary to make a rate adjustment for future production from the 1973-1974 wells due to the increased income taxes resulting from the repeal of the percentage depletion allowance.[29] When these and other adjustments are made to reflect actual costs and increased tax liability, the rate established in Opinion No. 699-H is increased to $1.01 per Mcf. The disparity between that rate and the rate prescribed for 1975-1976 biennium gas amounts to a 41% increase.

For these reasons, it is necessary to establish a new rate for gas from dedications and wells drilled on or after January 1, 1973 and prior to January 1, 1975. This rate would be applicable where:

(i) The sale is made from a well or wells commenced on or after January 1, 1973, and prior to January 1, 1975;

(ii) The sale is made pursuant to a contract for the sale of natural gas in interstate commerce

[28] See Exhibit 30, *infra*, for greater detail.

[29] See Int. Rev. Code of 1954, § 613A(b)(2), added by the Tax Reduction Act of 1975, P.L. § 94-12, 501.

for gas not previously sold in interstate commerce prior to January 1, 1973, except pursuant to the provisions of 18 C.F.R. §§ 2.68, 2.70, 157.22, or 157.29 (including sales made pursuant to those sections as modified by Federal Power Commission Order No. 491, *et al.*), or 18 C.F.R. § 2.75(n), where such a sale is initiated on or after January 1, 1973 and prior to January 1, 1975 provided that no certificate for the subject sale has been issued under the optional procedure (18 C.F.R. § 2.75).[30]

The rates prescribed herein will not apply to sales made pursuant to contracts executed prior to or subsequent to the expiration of the term of the prior contract where the sales were formerly made pursuant to the permanent certificates of unlimited duration under such prior contracts which expired of their own terms on or after January 1, 1973, or pursuant to contracts executed on or after January 1, 1973, where the prior contract expired by its own terms prior to January 1, 1973. Such sales will continue to be governed by the rate level, including appropriate annual escalations, prescribed in Opinion No. 699-H.[31]

Opinion No. 749[32] was issued by the Commission on December 31, 1975, establishing "just and reasonable" rates[33] for gas flowing in interstate commerce prior to January 1, 1973. In that proceeding a comprehensive review of rates for such gas was made which resulted in

[30] 18 C.F.R. § 2.56a(a)(3)(i) and (ii).

[31] 18 C.F.R. § 2.56a(a)(4) and (5).

[32] See Footnote 3, *supra*.

[33] Sections 4(a) and 5(a) of the Natural Gas Act, require that all rates received by a "natural gas company" be "just and reasonable." 52 Stat. 822, 823 (1938); 15 U.S.C. §§ 717c(a), 717d(a), (1970).

the establishment of national rates. Rather than allowing flowing gas subject to expiring contracts to increase to the rate prescribed herein, we believe that the rate adjustment for such gas under expiring contracts should be limited to the rate level prescribed in Opinion No. 699-H.

Many comments have been received on this issue. Some advocate the continuance of the policy followed in Opinion Nos. 699 and 639 of allowing the renewal contract to receive the new gas rate upon expiration of the term of the prior contract. Other comments argue for the abandonment of this policy.

Our determination of this issue in this proceeding, however, is governed by different circumstances than those which existed when Opinion No. 699 was issued. In that proceeding, the underlying reason for allowing gas subject to expiring contracts the new gas rate was to insure that the additional revenues generated by this class of sales would be available for expanded exploration and development programs. The level of exploratory and developmental dollars generated by this treatment will remain the same as that found necessary in Opinion Nos. 699 and 699-H by permitting an increase to those rates rather than to the rates prescribed herein.

We have carefully scrutinized the disparity between new prices and old prices to avoid an unreasonable increase in rates. By permitting expiring contracts to increase to the rate established in Opinion No. 699-H, a large increase in rates for "flowing gas" is avoided [34] while additional revenues are insured for expanded exploration and development programs which are required to discover and produce new supplies of natural gas.[35]

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[34] Over 500 Bcf of natural gas would fall into this category. This volume would significantly increase in future years.

[35] See Opinion No. 699, —— F.P.C. ——, slip opinion at 97.

Accordingly, a new national base rate of $1.42 per Mcf for post-January 1, 1975 gas and a revised rate of $1.01 per Mcf for 1973-1974 biennium gas will apply on or after the date of the issuance of this order. These rates are applicable to all qualifying sales of natural gas in interstate commerce, including oil-well (casinghead) gas, as well as gas-well gas, and shall remain in effect until modified by the Commission.

These rates are applicable only to jurisdictional sales of natural gas within the United States excluding Alaska and Hawaii ("the lower 48"). These national rates are subject to adjustment for Btu content, state and Federal production taxes, applicable gathering allowance, and the annual escalation provided herein.

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